APPENDIX.

The complete texts of Sections 113 and 114 (a) and the pertinent provisions of Section 114 (b) of the Revenue Act of 1934 are as follows:

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY.—The basis of property shall be the cost of such property; except that—

(1) INVENTORY VALUE.—If the property should have been included in the last inventory, the basis shall be the last inventory value thereof.

(2) GIFTS AFTER DECEMBER 31, 1920.—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds its impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information that the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner.

(3) TRANSFER IN TRUST AFTER DECEMBER 31, 1920.—If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a bequest or devise) the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made.

(4) GIFT OR TRANSFER IN TRUST BEFORE JANUARY 1, 1921.—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

(5) PROPERTY TRANSMITTED AT DEATH.—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall

be the fair market value of such property at the time of such acquisition. In the case of property transferred in trust to pay the income for life to or upon the order or direction of the grantor, with the right reserved to the grantor at all times prior to his death to revoke the trust, the basis of such property in the hands of the persons entitled under the terms of the trust instrument to the property after the grantor's death shall, after such death, be the same as if the trust instrument had been a will executed on the day of the grantor's death. For the purpose of this paragraph property passing without full and adequate consideration under a general power of appointment exercised by will shall be deemed to be property passing from the individual exercising such power by bequest or devise.

(6) TAX-FREE EXCHANGES GENERALLY.—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it.

(7) TRANSFERS TO CORPORATION WHERE CONTROL OF PROPERTY REMAINS IN SAME PERSONS.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of

stock or securities of the transferee as the consideration in whole or in part for the transfer.

(8) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—If the property was acquired after December 31, 1920, by a corporation.—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

(9) INVOLUNTARY CONVERSION.—If the property was acquired, after February 28, 1913, as the result of a compulsory or involuntary conversion described in section 112(f), the basis shall be the same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law (applicable to the year in which such conversion was made) determining the taxable status of the gain or loss upon such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion under the law applicable to the year in which such conversion was made.

(10) WASH SALES OF STOCK.—If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 118 of this Act, or corresponding provisions of prior income tax laws, relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of.

(11) PROPERTY ACQUIRED DURING AFFILIATION.—In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such

period of affiliation, shall be determined, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, without regard to inter-company transactions in respect of which gain or loss was not recognized. For the purposes of this paragraph, the term 'period of affiliation' means the period during which such corporations were affiliated (determined in accordance with the law applicable thereto) but does not include any taxable year beginning on or after January 1, 1922, unless a consolidated return was made, nor any taxable year after the taxable year 1928. The basis in case of property acquired by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be determined in accordance with regulations prescribed under section 141(b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932. The basis in the case of property held by a corporation during any period, in the taxable year 1929 or any subsequent taxable year, in respect of which a consolidated return is made by such corporation under section 141 of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, shall be adjusted in respect of any items relating to such period, in accordance with regulations prescribed under section 141(b) of this Act or the Revenue Act of 1928 or the Revenue Act of 1932, applicable to such period.

(12) BASIS ESTABLISHED BY REVENUE ACT OF 1932.—If the property was acquired, after February 28, 1913, in any taxable year beginning prior to January 1, 1934, and the basis thereof, for the purposes of the Revenue Act of 1932 was prescribed by section 113(a) (6), (7), or (9) of such Act, then for the purposes of this Act the basis shall be the same as the basis therein prescribed in the Revenue Act of 1932.

(13) PARTNERSHIPS.—If the property was acquired, after February 28, 1913, by a partnership and the basis is not otherwise determined under any of the paragraphs (1) to (12), inclusive, of this subsection, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partners shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property.

(14) PROPERTY ACQUIRED BEFORE MARCH 1, 1913.—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

(b) ADJUSTED BASIS.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(D) in the case of stock (to the extent not provided for in the foregoing subparagraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation, which was classified as a personal service corporation under the provisions of

the Revenue Act of 1918 or 1921, out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921).

(2) SUBSTITUTED BASIS.—The term 'substituted basis' as used in this subsection means a basis determined under any provision of subsection (a) of this section or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(A) by reference to the basis in the hands of a transferor, donor, or grantor, or

(B) by reference to other property held at any time by the person for whom the basis is to be determined.

Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in paragraph (1) of this subsection shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) BASIS FOR DEPRECIATION.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) BASIS FOR DEPLETION.—

(1) GENERAL RULE.—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection."

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 608

MILTON H. FRIEND, BERTHA F. LEVY AND ETHEL PACYNA, AS TRUSTEES OF THE TRUST ESTATE CREATED UNDER THE LAST WILL AND TESTAMENT OF HENRY FRIEND, DECEASED, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 180–192) is reported in 40 B. T. A. 768. The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 213–216) is reported in 119 F. (2d) 959.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 26, 1941 (R. 216–217). A petition for rehearing was denied June 13, 1941 (R. 217). The petition for writ of certiorari was filed September 12, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where petitioners, as testamentary trustees, become owners in fee through inheritance of certain tracts of realty subject to long-term leases, may they deduct from current rentals any amounts on account of depreciation or amortization on the alleged value of the lease contracts under Section 23 (1) of the Revenue Act of 1934?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, 48 Stat. 680:

> SEC. 22. GROSS INCOME.
>
> (a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities,

or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (U. S. C., Title 26, Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * * (U. S. C., Title 26, Sec. 23.)

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(5) *Property transmitted at death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. * * * (U. S. C., Title 26, Sec. 113.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23 (l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolenscence of property used in the trade or business may be deducted

from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. * * *

ART. 23 (l)–2. *Depreciable property.*— The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the inadequacy of the property to the growing needs of the business. It does not apply to inventories or to stock in trade, or to land apart from the improvements or physical development added to it. * * *

STATEMENT

This case involves income tax liability of testamentary trustees for the years 1934 and 1935 with respect to income from property formerly owned by the decedent. The facts found by the Board of Tax Appeals may be stated as follows:

At the time of the death of Henry Friend on August 1, 1932, he was the owner of two parcels of real estate. One of these, located at 6308-

6310 South Halsted Street, Chicago, was, in 1920, leased for a period of 99 years. The lessee paid the decedent $75,000 for the value of the improvements thereon. The lessee had the right to raze the buildings and to erect new buildings, the cost of which should be not less than $300,000. The lease also provided for an annual rental of $15,000 net from November 1, 1922, to October 31, 2019. This lease was acquired by the S. S. Kresge Company, and a supplemental agreement was entered into between Henry Friend, lessor, and S. S. Kresge Company, lessee, whereby the lessee was permitted to erect a building costing not less than $125,000, with a rental of $18,000 per year. This building was erected by the lessee in 1925 (R. 181).

The other parcel of real estate, located at 6312–6314 South Halsted Street, Chicago, was leased for a term of 25 years, beginning with 1924, to the F. W. Woolworth Company at an annual rental of $20,000. Subsequently, a second Woolworth lease was executed covering the demised premises from the end of the period covered by the first lease, for another period of 25 years, at an annual rental of $25,000. Pursuant to these two leases, the Woolworth Company erected a building upon the premises at a cost of $125,000 (R. 181–182).

It was the petitioners' contention that the estate of Henry Friend acquired upon his death, on August 1, 1932, leasehold estates upon the two properties, 6308–6310 and 6312–6314 South Hal-

sted Street, and also reversionary estates in respect of the properties; that since the Commissioner determined the values of these estates separately in the determination of the estate tax liability of the estate of Henry Friend, placing a very large value upon the leasehold estates and a very nominal value upon the reversionary estates, the estate is entitled to deduct from the capitalized value of the leasehold estates a reasonable amount for the amortization of those leasehold estates during the life of the leases and that the taxable income from the properties was the net rents received less reasonable amounts for amortization (R. 182). The deductions were denied by the Board of Tax Appeals and its decision was affirmed by the court below.

ARGUMENT

The petitioners do not dispute that if the decedent were still alive the rentals subject to tax could not be reduced by any deduction for exhaustion or depreciation of the leaseholds (R. 215). Their sole contention in essence is that the leaseholds became capitalized at his death and that then, for the first time, the rentals had to be applied against the new capital base, through allowances for depreciation or exhaustion, before they could be subject to tax.

Whether the future rentals may be capitalized at the time of decedent's death for the purpose of determining future gain or loss with respect to the leasehold has been recently considered by

this Court in *Hort* v. *Commissioner,* 313 U. S. 28, and that decision is dispositive of the issue herein.

In the *Hort* case, the taxpayer had inherited an office building in 1928 subject to an advantageous long-term lease. In 1933, he was paid a large amount by the tenant for cancellation of the lease. The Government sought to impose a tax upon the amount thus received in 1933. The taxpayer contended that the leasehold became capitalized in 1928, that what he had received in 1933 was simply a return of capital, and indeed that it was less than the amount of the new 1928 basis with the consequence that he sustained a deductible loss. This Court rejected those contentions and held that no portion of the amount received could be regarded as a return of capital for tax purposes. It was not (p. 31) "a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father."

Similarly here, no part of the annual rentals can be treated as a return of capital based upon capitalization of the leasehold at the decedent's death. The statutory provisions here invoked by petitioners were likewise available (as they appeared in a predecessor revenue act) in the *Hort* case, but were apparently not deemed to be of any controlling significance.

In asserting that (Pet. 20) the decision below means that no depreciation can ever be taken on *buildings* inherited, the petitioners clearly indicate that they have misconceived the basis for the

decision below. Buildings as such are depreciable property but the petitioners here were not entitled to such depreciation because of the provisions of the long-term leases under which the lessees were plainly entitled to the depreciation. The rental payments constituted income flowing from and incident to the ownership of the premises, and were properly subjected to income tax.

CONCLUSION

The decision below is correct and there is no conflict. The basic issue has been thoroughly explored in this Court's recent decision in the *Hort* case, and petitioners have suggested no reason for reexamination. The petition should be denied.

Respectfully submitted.

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OCTOBER 1941.

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